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Ex Parte Presentation

Marlene H. Dortch, Secretary
Federal Communications Commission
The Portals
445 12th Street, S.W., TW-A325
Washington, DC 20554

**Re: CC Docket No. 96-128, Illinois Public Telecommunications Association,
Petition for Declaratory Ruling**

Dear Ms. Dortch:

The attached document is submitted on behalf of the American Public Communications Council for inclusion in the record of this proceeding. The document responds to a question raised by Wireline Competition Bureau Associate Chief Donald Stockdale at a recent ex parte meeting, regarding whether, when the Commission stated in *Wisconsin Public Service Commission*, Memorandum Opinion and Order, 17 FCC Rcd 2051 (2002), that the new services test required the use of forward-looking costs, the Commission altered the requirements of the test.

Sincerely,



Robert F. Aldrich

cc: Donald Stockdale
Albert Lewis
Pamela Arluk
Lynne Engledow

AMERICAN PUBLIC COMMUNICATIONS COUNCIL
THE NEW SERVICES TEST AND FORWARD-LOOKING COSTS

October 2006

When the Commission, in the *Wisconsin Order*,¹ ruled that the NST requires the use of forward-looking costs, it did not alter the new services test ("NST"). In the *ONA Tariff Order*,² the Commission expressly found that the NST requires the use of prospective, or forward-looking, costs:

We conclude that, for purposes of this proceeding, prospective costs are the economically relevant costs to use to support BSE rates, because they represent the costs a profit maximizing firm would consider in making a business decision to provide a new service. Historical costs associated with plant already in place are essentially irrelevant to the decision to enter a market since these costs are "sunk" and unavoidable and are unaffected by a new product decision.

* * *

[T]he filed ONA rates, to the extent they are based on the carrier's technology mix and costs associated with embedded investment, are unjust and unreasonable. We further determine, under our prescriptive authority contained in Section 205 of the Communications Act, that ONA rates developed from technology mix and associated cost data which reflect a prospective view of the carrier's investment are, to the extent that rate levels are determined by these factors, just and reasonable.

Id. at 454-55 ¶¶ 40-41.

In addition, in other early NST decisions there are numerous indications that the Commission consistently required the use of forward-looking costs under the NST. A useful source of information for this purpose is the Commission's *VDT Order*.³ In that decision, the Commission established rules for pricing local exchange carriers' video

¹ *Wisconsin Public Service Commission*, Memorandum Opinion and Order, 17 FCC Rcd 2051 (2002) ("*Wisconsin Order*"), *aff'd* *New England Pub. Comms. Council, Inc. v. FCC*, 334 F.3d 69 (D.C. Cir. 2003).

² *Open Network Architecture Tariffs of Bell Operating Companies*, Order, 9 FCC Rcd 440 (1993).

³ *Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58 and Amendments of Parts 32, 36, 61, 64, and 69 of the Commission's Rules to Establish and Implement Regulatory Procedures for Video Dialtone Service*, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244 (1994) ("*VDT Order*").

dialtone services. The Commission determined that the regulated portion of these services (the transmission service as opposed to the nonregulated provision of video content) should be initially priced based on a “cost-based showing under the [NST].” *Id.* at 340 ¶ 207.

In order to clarify how the NST would allow for review of cross-subsidy and cost allocation issues, the Commission reviewed the development and application of the NST up to that time. *Id.* ¶ 208. In our view, the precedents examined by the Commission in the *VDT Order*, and the *VDT Order* itself, indicate that in developing the NST the Commission consistently held that a direct-cost “floor” for pricing a new service by means of *forward-looking cost* methodologies, *i.e.*, methodologies that either actually identify the *incremental costs* of the service or that utilize a reasonable proxy for *incremental costs*. The Commission’s decisions make it clear that for NST purposes, the Commission considered “direct” costs to be the forward-looking *incremental costs* of the service.

The NST was initially used to review AT&T’s pricing of new services in the context of the AT&T price caps regime. As initially formulated, the NST had no price ceiling, but only a price floor, the purpose of which was to prevent predatory pricing or cross-subsidy. At that time, the Commission determined that a price floor was more appropriately based on *marginal costs* rather than on fully distributed costs, but it believed that “*marginal costs* are essentially theoretical . . . and cannot be generated through conventional accounting methods.”⁴ As a way around this problem, the Commission adopted the “net revenue test” as a “proxy for a *marginal cost* standard.” *Id.* (emphasis added). The net revenue test “required a showing that the service would increase net revenues for price capped services [*i.e.*, increase the amount by which revenues exceeded costs for a “basket” of services] within a relatively short period of time.” *VDT Order* at 341 ¶ 210. By means of the net-revenues proxy, the Commission concluded, it had succeeded in “plac[ing] an *incremental cost* floor under new service prices.” *Id.* at 342 ¶ 211 (emphasis added).

When the Commission developed price caps rules for LECs, it decided to also apply the NST to LECs, but with a price ceiling as well as a price floor. *Id.* The Commission considered various methods of setting price ceilings. *Id.* at 342-43 ¶¶ 211-12. In settling on a method, the Commission recognized that:

LECs that have introduced new service offerings in the past have provided cost support identifying the direct costs of the new service as well as the associated overheads. LECs typically submit engineering studies, time and wage studies, or other cost accounting studies in support of the new offering. The purpose of these studies is to identify the direct costs of providing the new service, absent overheads.⁵

⁴ *Policies and Rules Concerning Rates for Dominant Carriers*, 4 FCC Rcd 2873, 3124 ¶ 521 (1989) (emphasis added).

⁵ *Policy and Rules Concerning Rates for Dominant Carriers*, Order on Reconsideration, 6 FCC Rcd 2637, 2695 ¶ 128 (1991).

The Commission required LECs to use this method as the foundation for establishing a maximum price ceiling, which comprised direct costs plus an appropriate overhead loading.

Later, the Commission recognized that these same methods of determining direct costs that it mandated for purposes of establishing price ceilings could also be used to establish a price floor, rendering the “net revenue test” superfluous.⁶ The reason, the Commission concluded, was that the LECs had developed cost methodologies that were now capable of identifying the forward-looking *incremental costs* of a new service without resort to proxies. As the Commission explained in the *VDT Order*:

The Commission’s substantive standard for determining whether new service rates are unreasonably low was not changed: a price is unreasonably low if it is predatory; a predatory price is one that does not recover the *incremental costs* of providing a service. Conversely, a rate that recovers all of the *incremental costs* of a new service is not predatory.

VDT Order at 343 ¶ 213 (emphasis added). In describing in detail the type of cost showing that it expected for video dialtone offerings, the Commission continued to recognize the equivalence of direct costs and *incremental costs*:

Under our established practice, *direct costs* include the costs and cost components associated with the primary plant investment that is used to provide the service. In the case of video dialtone, some of these plant costs will be *incremental costs* associated with plant dedicated to video dialtone service. The *direct costs* of video dialtone will also include any *incremental costs* that are associated with shared plant used to provide video dialtone and other services, that is, *costs of shared plant that are caused by the carrier’s decision to offer video dialtone service*. . . . We recognize and accept the challenges inherent in determining *which costs are truly the consequences of a carrier’s decision to provide video dialtone service, i.e., are incremental costs*.

Moreover, we expect LECs to include in *direct costs* a reasonable allocation of other costs that are associated with shared plant used to provide video dialtone and other services.

* * *

For video dialtone . . . we direct carriers to treat costs in other accounts as *direct costs* if those costs are reasonably identifiable as *incremental costs* of video dialtone service.

⁶ *Amendment of Part 69 of the Commission’s Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture*, 7 FCC Rcd 5235, 5237 (1992).

Id. at 345 ¶¶ 217-19 (emphasis added).

In summary, the Commission's early NST decisions consistently treat direct costs as equivalent to *incremental costs*, i.e., forward-looking costs. Although in many of the examples above, the Commission was focused on the use of direct costs to set a *floor* for NST pricing, it is the same direct costs that are used as the foundation for building up to a price *ceiling*. In both cases, therefore, it is forward-looking *incremental costs* that have always served as the basis for identifying direct costs under the NST. In requiring the Bell Companies to continue to use forward-looking costs under the NST, the Commission did not alter the NST requirement.